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EMPLOYEE STOCK OWNERSHIP PLAN

UNITED STATES DISTRICT COURT

CENTRAL DISTRICT OF CALIFORNIA

HILDA L. SOLIS,
Secretary of the United States
Department of Labor,

Plaintiff,

vs.

GREATBANC TRUST COMPANY,
SIERRA ALUMINUM COMPANY,
and THE SIERRA ALUMINUM
COMPANY EMPLOYEE STOCK
OWNERSHIP PLAN,

Defendants.

Case No.: 5:12-cv-01648-R (DTBx)

REPLY MEMORANDUM OF POINTS AND AUTHORITIES IN SUPPORT OF SIERRA DEFENDANTS' MOTION TO DISMISS

DATE: March 4, 2013
TIME: 10:00 a.m.
LOCATION Courtroom 8, 2nd Floor
312 North Spring Street
Los Angeles, CA
JUDGE: Hon. Manuel L. Real

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REPLY MEMORANDUM OF POINTS AND AUTHORITIES

I. INTRODUCTION.

In its zeal to convince the Court that the Sierra-GreatBanc indemnification agreement violates ERISA section 410(a), the Department glosses over or ignores statutory and contractual terms, omits important elements of a key case it cites, and never squarely addresses the fact that it is asking the Court to create new law that would significantly expand the reach of section 410(a). The Department's position, if adopted, would invalidate all ESOP fiduciary indemnification agreements where the company that sponsors the ESOP (*i.e.*, the indemnitor) is 100% owned by the ESOP.[1] This is a position that is undermined by the Department's own regulations, and finds no support in the language of Section 410(a) (which treats all ERISA-covered plans equally) or in the existing case law.

The most significant case relied upon by the Department and the one the Department trumpets the loudest, *Johnson v. Couturier*, 572 F.3d 1067 (9th Cir. 2009), has two critical features that undercut the agency's reliance on it, yet they somehow are missing from or are not squarely addressed in the Department's brief. First, the indemnity agreement in that case did not, like the agreement at issue here, preclude indemnity in the event of a breach of fiduciary duty. Rather it precluded indemnity only for damages and costs attributable to the fiduciary's "deliberate wrongful acts" or "gross negligence." Damages suffered and costs incurred as a result of a breach of fiduciary duty that did not rise to the level of a "deliberate wrongful act" or "gross negligence" would have to be indemnified under the *Couturier* agreement. The Department neglects to point out this critical fact. Second, unlike the facts alleged in the Department's complaint here, the wholly-ESOP-owned company in *Couturier* had been liquidated and all of its funds

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[1] Capitalized terms not otherwise defined herein have the same meaning as provided in the Memorandum of Points and Authorities in Support of Sierra Defendants' Motion to Dismiss (Dkt. No. 23-1) and in the Department's Omnibus Opposition to Defendants' Motions to Dismiss (Dt. No. 28).

earmarked for payment to the ESOP's participants. This meant that any proceeds used to indemnify the fiduciaries (whom the court determined had likely breached their fiduciary duties) would come "dollar for dollar" straight out of the proceeds for the ESOP participants. *Couturier*, 572 F.3d at 1080. This was a key fact in the case that, for the Ninth Circuit, took it outside a Department regulation that otherwise would have allowed the indemnification to go forward (assuming the defendants could have shown that they were not being indemnified for a breach of fiduciary duty). There is nothing in the Department's complaint in this case to suggest that any such facts are present here, nor could the Department make such allegations. Yet its opposition brief here only obliquely references this aspect of the *Couturier* decision with incomplete quotes that omit the "dollar for dollar" language, despite the fact that the "dollar for dollar" argument was made by the Department itself in an amicus brief it filed in that case. A review of the Department's arguments in its *Couturier* amicus brief leaves no doubt that the Department understood, at least then, just how truly unique the facts of *Couturier* were.

Because the statute, regulations, and cases do not support the Department's attempt to make new law under section 410(a), the Court should grant the Sierra Defendants' Motion to Dismiss with prejudice.

II. <u>ARGUMENT</u>.

The Department argues that the indemnification agreement between Sierra and GreatBanc is invalid under ERISA section 410(a) because: (1) it is the ESOP, the owner of 100% of Sierra's stock, not Sierra, that effectively indemnifies GreatBanc under the agreement, in violation of a Department regulation that construes section 410(a) to prohibit ERISA plans from indemnifying their fiduciaries, and (2) the agreement allows Sierra to advance defense fees without a guarantee of recovery. Opp. Br. at 8-12. Neither position withstands scrutiny.

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A. The Statute, the Department's Own Regulation, and the Cases Support that Sierra, not the ESOP, has the Obligation to Indemnify GreatBanc.

The Department argues that the Sierra-GreatBanc indemnification agreement violates ERISA section 410(a) and a Department regulation because the ESOP, not Sierra, is the entity that indemnifies GreatBanc. In support, the Department offers the following (flawed) syllogism:

1. Section 410(a) prohibits agreements that purport to relieve a fiduciary of liability for any duty imposed by ERISA;
2. The Department adopted a regulation in 1975 that, consistent with Section 410(b) – a provision that exempts most commercial fiduciary insurance from section 410(a) – approves indemnification agreements which leave a breaching fiduciary liable but merely permit another party to satisfy the liability in the same manner as insurance;
3. The regulation also states that an indemnification agreement that would require an employee benefit plan to indemnify the plan's own fiduciary would violate section 410;
4. The ESOP here owns 100% of Sierra's stock;
5. Because the ESOP owns 100% of Sierra's stock, it will be the ESOP that ultimately indemnifies GreatBanc;
6. Case law supports the Department's argument;
7. The Sierra-GreatBanc indemnification agreement therefore violates section 410(a).

See Opp. Br. at 1-2, 8-9, 12. The Department's conclusion is wrong because premises 5 and 6 are wrong. What the Department really is trying to do is have the judiciary rewrite ERISA section 410(a) to add a special rule precluding ESOP sponsors like Sierra from indemnifying the fiduciaries they hire to work on behalf of

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the ESOP. The Department's own regulations and the case law refute the Department's position.

1. The Department's own regulations distinguish an ESOP from its sponsor.

Premise 5 in the Department's reasoning in this litigation – that the ESOP, not Sierra, is indemnifying GreatBanc because the ESOP owns 100% of Sierra's stock – is undercut by two of the Department's own regulations: the regulation disapproving of agreements under which a plan indemnifies its own fiduciary, and the regulation defining plan assets.

The first regulation is an Interpretative Bulletin that, according to the Department's opposition brief, stands for the proposition that ERISA section 410(a) renders "void any arrangement for indemnification of a fiduciary of an employee benefit plan by the plan." Opp. Br. at 2:1-4 (citing 29 C.F.R. § 2509.75-4). But the portion relied upon by the Department does not tell the full story. The regulation goes on to explain that the problem with such an arrangement is that it would amount to an exculpatory clause, because the plan would have no recourse against the fiduciary. *Id.* By contrast and in further explanation of its announced rule, the regulation identifies as an example of a permitted indemnification agreement the indemnification of a plan fiduciary by an employer. *Id.* The regulation, thus, does not purport to treat an ESOP and the company that sponsors it as interchangeable. They are separate and distinct in the regulation's own example.

This distinction is carried through to and is a bedrock feature of the Department's regulation defining plan assets. *See* 29 C.F.R. § 2510.3-101. Under the relevant provisions of that regulation, which begin with the phrase "notwithstanding any other provision of this section," when an employee benefit plan owns all of the outstanding shares in an entity, as the complaint here alleges is the case with respect to the ESOP and Sierra, the plan's assets generally include not only the shares but also all of the underlying assets owned by the entity, except when

the plan is an ESOP, in which case ***the company's underlying assets are not treated as the ESOP's assets***. *See* 29 C.F.R. § 2510.3-101(h)(3); *see also Couturier*, 572 F.3d at 1080 (describing 29 C.F.R. § 2510.3-101(h)(3) as "establishing that corporate assets are not plan assets where the plan is an ESOP"). This regulation is just one of a number of ESOP-specific rules in the regulations and the statute that recognize and address, when material, the sometimes unique nature of ESOPs. *See, e.g.,* ERISA § 407(b), 29 U.S.C. § 1107(b) (expressly exempting ESOPs from the limitations on investing in sponsor stock that apply to most other plans). Significantly, there is no special ESOP regulation or other rule in ERISA that modifies the Department's above-quoted regulation and treats indemnification agreements under ESOPs differently from indemnification agreements under other plans.

The fact that ERISA and the Department's own regulations allow plan-sponsor indemnification agreements that function like commercial insurance to exist, and recognize the separateness of ESOP assets and company assets, means the Department simply has no legal foundation for asserting now as a litigating position that Sierra's indemnification obligation should be treated as the ESOP's. Because the Department's litigation position is entirely unsupported, and even to some extent contradicted, by existing case law, agency regulations, and other binding agency interpretations, it is not entitled to *Chevron* deference from this Court. *See Price v. Stevedoring Servs. of Am., Inc.*, 697 F.3d 820, 830-31 (9th Cir. 2012). Accordingly, on this basis alone the Department's claim fails and the Court should grant this motion to dismiss.

2. The case law refutes the Department's position.

Premise 6 in the Department's reasoning in this litigation – that the cases support its position – is undermined by the very cases the Department cites. This occurs in at least two ways.

First, none of the indemnification arrangements at issue in the Department's cases is actually like the Sierra-GreatBanc indemnification agreement. The

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Department never squarely addresses this issue. As we noted in our opening brief, the indemnification agreements at issue in *Couturier* provided indemnity "for all liability incurred in [Defendants'] service, provided 'any such liability did not involve 'deliberate wrongful acts' or 'gross negligence.'" Opening Br. at 8:17-19 (quoting *Couturier*, 527 F.3d at 1074). Thus, even damages and costs incurred as a result of a breach of ERISA fiduciary duty would have to be indemnified unless the breach rose to the level of a deliberate wrongful act or gross negligence. As the Ninth Circuit put it, the agreement would require indemnification of the defendants "even if they violated the ERISA 'prudent man' standard of care." Opening Br. at 8:23-24 (quoting *Couturier*, 527 F.3d at 1078). The Sierra-GreatBanc agreement, in contrast, precludes indemnification for breaches of fiduciary duty that are determined to have occurred.

Similarly, and again as we noted in our opening papers, in *Fernandez v. K-M Industries Holding Co., Inc.*, 646 F. Supp. 2d 1150 (N.D. Cal. 2009), "the indemnification agreement at issue would have left the company responsible and liable for the trustee's 'breach of fiduciary duty unless the breach involved gross negligence or willful misconduct.'" Opening Br. at 9:1-3 (quoting *Fernandez*, 646 F. Supp. 2d at 1156). The agreement in *Fernandez* is very different from the Sierra-GreatBanc agreement. In *Donovan v. Cunningham*, 541 F. Supp. 276 (S.D. Tex. 1982), another of the Department's cases, the indemnification agreement's language is not recited or described by the district court, nor is it quoted or described by the Fifth Circuit on appeal in its decision partially overturning the District Court. *See Donovan v. Cunningham*, 716 F.2d 1455 (1983). The Department has not, and cannot, advance a single case in which a Court invalidated pursuant to ERISA section 410(a) an indemnification agreement which, specifically and explicitly, ***excludes*** breaches of ERISA fiduciary duties from the scope of indemnifiable costs.

Second, the company in *Couturier* had been liquidated through an asset sale and no longer was an operating company. *See Couturier*, 572 F.3d at 1075. The

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only thing left to do was distribute the remaining post-sale proceeds to the ESOP and its participants once the company's litigation expenses and indemnification obligations under the agreement had been paid. The Department's own amicus brief before the Ninth Circuit in *Couturier* does an excellent job of explaining exactly what makes *Couturier* so different from this case:

> Here, because the company is entirely owned by the ESOP, and because the company's plan of liquidation provides for the payment of TEOHC's remaining funds to ESOP participants as company shareholders, any proceeds that are used to pay for the defendants' legal expenses – to defend in a suit in which they are accused of fiduciary misconduct with respect to the ESOP – *will reduce, dollar for dollar, the distributions that the ESOP participants will receive*, even if the defendants are ultimately found liable under ERISA, as long as they are not adjudged grossly negligent under state law, a standard much lower than the exacting fiduciary standards imposed by ERISA.

Brief for the Secretary of Labor as Amicus Curiae Supporting Appellees and Requesting Affirmance at 13-14, Johnson v. Couturier, No. 08-17369 (9th Cir. January 30, 2009) (Dkt. No. 41-1), 2009 WL 2444302 (emphasis added). *See also* Brief of the Secretary of Labor as Amicus Curiae in Support of Motion for Preliminary Injunction at 7:24-8:2, Johnson v. Couturier, No. 2:05-cv-02046-RRB-KJN (E.D. Cal. Sept. 24, 2008) (Dkt. No. 389-1) ("Although the underlying assets of an ESOP-owned company are not generally plan assets, the payment of the fiduciaries' fees to defend ERISA claims from the accounts would directly reduce the amount available to the plan and reduce the benefits available for distribution to participants and beneficiaries."). *Couturier* was thus a case in which the costs of indemnification were to come directly out of the pockets of plan participants and beneficiaries, because the company had liquidated and had a fixed sum available to distribute. Nothing like that is alleged (or could be alleged) here, where Sierra is not (and could not be) alleged to have been liquidated. Yet this fact never made it into the Department's brief opposing the defendants' motions to dismiss in this case.

One of the Department's own rules in the plan-asset regulation makes an important distinction between ownership of shares in an operating company and

ownership of shares in other companies, which is consistent with the distinction we note between *Couturier* and this case. Under that regulation, which applies to plans that own less than all of the shares of a company, the company's underlying assets are not treated as assets of the plan as long as the company is an operating company or is regulated by the federal securities laws. *See* 29 C.F.R. § 2510.3-101(a)(2).

Because the Department's complaint does not allege facts to support that the Sierra-GreatBanc indemnification agreement is like the agreements in *Couturier* and *Fernandez* or that Sierra is merely a pool of cash awaiting distribution to ESOP participants, Count II fails to state a claim.

B. The Department Fails to Identify Where a Workable Line Can Be Drawn for Determining When a Breach of Fiduciary Duty has Actually Occurred.

As established in our opening brief, the Sierra-GreatBanc agreement provides both that indemnification is unavailable when there is a final judgment finding a breach of fiduciary duty, and that any advancements must be returned "in the event it is determined the Indemnitee is not entitled to retain such amounts hereunder." Opening Br. at 3. The Department tries to caricature the defendants' position as asserting that ERISA section 410(a) precludes indemnification only when there has been a final judgment finding a fiduciary breach. *See* Opp. Br. at 12:16-18. To the contrary, the defendants have fully pointed out, as the statute plainly states, that an agreement which purports to indemnify breaches of ERISA fiduciary duties is void as against public policy. The agreement here does not purport to indemnify fiduciary breaches. What the Sierra Defendants have established and the Department has failed to meaningfully address, is that there is no workable line under the law for reliably determining whether indemnification is allowed, other than a final adjudication of breach or a court's determination that advancements must be returned.

The Department argues that "the 'primary definition of liability' is 'the quality or state of being legally obligated or accountable; legal responsibility to another or to

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society, enforceable by civil remedy or criminal punishment.'" Opp. Br. at 13:21-27 (quoting *Herrera v. LCS Fin. Servs. Corp.*, C09-02843 THE, 2009 WL 2912517, at *7 (N.D. Cal. Sept. 9, 2009)). Even accepting that definition of liability for argument's sake, as the Department knows "liability for any responsibility, obligation, or duty under" ERISA is not necessarily established in the context of a settlement of a lawsuit. "For example, parties may settle [a lawsuit] to avoid a nuisance or for wholly gratuitous reasons." *Woodard v. Metropolitan Life Ins. Co.*, No. 3:08-734-JPG-PMF, 2009 WL 2177306, at *2 (N.D. Ill. July 21, 2009) (citing *Hooper v. Demco, Inc.*, 37 F.3d 287, 292 (7th Cir. 1994)). In a case like this one, with a particularly weak underlying fiduciary breach claim, defendants may chose to settle simply because settling is less expensive than litigating. Under the Department's proposed framework, however, a plan fiduciary would be incentivized to litigate even the weakest case to a victorious final judgment, in order to ensure its right to reimbursement of costs incurred defending those spurious claims.[2] Ultimately, the indemnifying company would be responsible for all of the costs of litigating every spurious claims to final judgment because "[h]ow could anyone take seriously the proposition that ERISA forbids the indemnification of fiduciaries *wrongly* accused of misconduct[.]" *Packer Engineering, Inc. v. Kratville*, 965 F.2d 174, 176 (7th Cir. 1992) (emphasis in original).

Moreover, the Department's parade of horribles, in which the "settlement loophole . . . effectively allows fiduciaries to stick ERISA plans with the bill for every case alleging a fiduciary breach, no matter how meritorious the claim," completely ignores the role the Department itself has in negotiating and endorsing

[2] *See, e.g.*, Dep't of Labor Advisory Opinion 77-66, 77-66A, 1977 WL 5446, at *11 (Sept. 9, 1977) ("It may be argued, however, that any reimbursement by the Fund of amounts paid in settlement of pending or threatened litigation alleging a breach of fiduciary duty would not be permitted under section 410 and other provisions of ERISA. If this interpretation were to be adopted here, plan fiduciaries would be extremely reluctant to settle any such litigation. If the claims were clearly spurious, the fiduciary would obviously prefer to be exonerated by a final judgment, since the Fund would then be liable for the fiduciary's expenses.").

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any settlement. Opp. Br. at 16:25-28. The Department's discussion of this "loophole" reads as if a plan fiduciary has the power to settle cases on its own terms, without any input from a plaintiff. *See, e.g.*, Opp. Br. at 15:1-6 ("If [section] 410(a) demanded an adjudicated breach then, under Defendants' logic, settling fiduciaries could obtain indemnification from their ERISA plans even if they openly admitted in their settlement agreements that they in fact breached their fiduciary duties."). As we all know, that is not the case. If the Department, or any other plaintiff for that matter, believes strongly in the merits of their claims against plan fiduciaries, it is free to insist that the terms of any settlement invalidate indemnification provisions, making the fiduciary completely financially responsible for all costs incurred. In negotiating the terms of any settlement, the Department holds the power to decide who to "stick . . . with the bill for [a] case alleging a fiduciary breach[.]" *Id*. If the Department is not satisfied with its ability to negotiate sufficiently adequate settlement terms, then it "retain[s] the option to pursue [its] litigation until liability has been judicially determined[,]" just like any other litigant. *Martinez v. Barasch*, No. 01Civ.2289(MBM)(JCF), 2006 WL 435727, at *4 (S.D.N.Y. Feb. 22, 2006). The Department also is free to intervene in cases, which it sometimes does, where it believes indemnification is unsupported.

Furthermore, the Department's 1977 Advisory Opinion providing a "mechanism by which fiduciaries can obtain indemnification for settlement payments that fully complies with [section] 410(a)" has no basis in law. Opp. Br. at 22:5-7. In that Advisory Opinion, the Department proposed a system which would require a "written opinion of independent legal counsel . . . that . . . the acts of the fiduciary in question do not constitute a breach of a fiduciary obligation" before any plan fiduciary could obtain indemnification for settlement of a lawsuit. Dep't of Labor Advisory Opinion 77-66, 77-66A, 1977 WL 5446, at *12 (Sept. 9, 1977). In the thirty-five years since the Department issued this Advisory Opinion, the sole Court to consider it rejected it: "Though such a procedure would reduce the risk that

wrongdoers would recover expenses from plans they had injured, there is no legal authority for imposing it here." *Martinez*, 2006 WL 435727, at *4. Yet the Department now asks this Court to find that the position taken in the Advisory Opinion naturally flows from the prohibitions of ERISA section 410(a) (despite the absence of supporting language in the statute) and become the first court to endorse the 35-year-old Advisory Opinion. *See* Opp. Br. at 23:9-12 ("In the absence of such a review by independent legal counsel, any indemnification paid by Sierra to GreatBanc for the latter's settlement of this case would violate [section] 410(a)."). The Advisory Opinion has no basis in the text of ERISA or in the case law, and this Court should reject it.

What the Department really is trying to achieve through this claim is a judicial pronouncement of a special rule for ESOP-related indemnification agreements, under which a plan fiduciary is not entitled to indemnification when accused of fiduciary breaches until proven innocent. The Department wants this rule to apply, regardless of the strength of the claims or the exclusionary language contained in the indemnification agreement, because the ESOP could at some point indirectly bear the financial burden of defense costs or settlement. *See, e.g.*, Opp. Br. at 10:22-11:10. Such a system is entirely unworkable, because it would be impossible for a company or an ESOP to ever convince an independent entity to serve as a plan fiduciary. *See* Dep't of Labor Advisory Opinion 77-66, 77-66A, 1977 WL 5446, at *9 (Sept. 9, 1977) (It would not be possible "to retain highly-qualified, independent, professional managers without indemnification provisions[.]"). The Department's approach would turn the basic legal presumption of innocence on its head. The Court should reject it.

C. Sierra's Advancement of Defense Costs is Proper

Lastly, the Department argues that ERISA section 410(a) prohibits Sierra from advancing defense fees to GreatBanc, regardless of the indemnification agreement's express contractual provisions insuring reimbursement in the event the Court

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determines GreatBanc is not entitled to retain them, unless GreatBanc can demonstrate its ability to fulfill the contractual reimbursement obligation. *See* Opp. Br. at 23:17-25:11. Under this approach, the court in every ESOP case asserting breach of fiduciary duty would be required to conduct an evidentiary hearing to determine whether the fiduciary has sufficiently demonstrated its ability to fulfill the contractual obligation. *See* Opp. Br. at 24:19-24. There is no basis for such a requirement in the text of ERISA or in the case law interpreting it. *See Moore v. Williams*, 902 F. Supp. 957, 966-67 (N.D. Iowa 1995) ("Although ERISA prohibits, as against public policy, any agreement that purports to relieve a fiduciary of responsibility under ERISA for breach of fiduciary duty, that prohibition does not prevent advancement of expenses until liability is determined.").

Even in *Couturier* the plaintiff had to meet the exacting standards for granting a preliminary injunction before the advancement of legal fees could be enjoined. *See Couturier*, 572 F.3d at 1078-79. The Department here has made no showing of a likelihood of success on the merits or establishment of irreparable harm, both of which the Ninth Circuit held were required prior issuing an injunction terminating the advancement of attorneys' fees. *See id.* at 1079 ("We conclude that the district court did not abuse its discretion in preliminarily enjoining TEOHC from advancing Defendants' defense costs. Plaintiffs established all four elements of the governing standard[.]"). There is no legal basis for the Department's position here.

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III. CONCLUSION

The Court should reject the Department's attempt to have the judiciary rewrite the scope of ERISA section 410(a) beyond the boundaries of the statute that Congress actually passed and codified at 29 U.S.C. § 1110(a). The Court should dismiss the Department's Second Claim for Relief with prejudice.

Dated: February 19, 2013

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